



DON'T CALL IT A CULT – IT'S THE CHURCH OF MATH

We at Cooke & Bieler spend our days immersed in the details of fundamental, company-specific analysis. We add value for our clients by understanding the micro-economics of companies and industries and identifying undervalued securities. We don't usually weigh in on the latest investing trend or capital market controversy. Occasionally, though, conventional wisdom becomes so untethered from basic economic reality that we feel compelled to comment. In doing so, we feel like the boy pointing out the naked emperor – almost embarrassed to call attention to the obvious. But when we look around and see so many oblivious to the power of mathematics, we are able to overcome our reticence and raise our voice (well, keyboard).

In short, we are writing to you in defense of equities – an asset class that some in our industry have taken to calling a “cult”. According to these critics, equities are capable of generating excess returns thanks only to a loop in which buyers beget rising prices which beget more buyers. These critics also claim that, with stock prices still below their March 2000 highs, this loop has been running and will continue to run in reverse. Cured of their devotion to this absurd cult, investors apparently would be wise to de-risk their portfolios and accumulate bonds regardless of price.

Our counterclaim to this nonsense is straightforward. Absent infinite compression in valuations, math (and a little bit of logic) dictates that equity returns will exceed bond returns over time.

Indeed, the individual needs of investors should drive asset allocation, so we are not suggesting all reallocations toward bonds are irrational. We are suggesting – no, simply saying – much of the reasoning we hear for such reallocations makes no sense. For all the time and energy spent understanding and forecasting them, capital markets are really quite simple: The returns investors receive are driven by the fundamentals of businesses in which they invest.

One would think, given the ironclad logic of this premise, most analysts would spend their time seeking to understand the fundamentals underlying their investments. Alas, not so. Too many investors spend their time analyzing past returns in search of clues to the future and in doing so end up trapped in a logical cul-de-sac with signs pointing in three different directions:

- Returns tend to be serially correlated (things that go up keep going up),
- but ultimately revert to some average return (what goes up must come down),
- and it's really hard to know when returns will begin to revert and what the mean is to which they are reverting (past performance does not guarantee future results).

Luckily, there does exist an escape from this dead end and it is called work, or, less concisely, fundamental analysis. Over time, firms can return to providers of capital exactly as much as they earn on the capital. How those returns are split depends on the contractual arrangements made between equity owners and debt owners and the laws and customs that govern those arrangements. Understanding what debt holders get is relatively easy; they receive interest on specified terms and as long as the firm is worth more than its debt, their investment gets repaid at a specified time. Equity returns are less fixed; stockholders get whatever doesn't go to creditors, or, if creditors can't be repaid in full, nothing. The best way – really the only way – to forecast what your return is going to be via equity ownership is to understand the returns of the business and subtract what is owed to creditors.

And if one performs this analysis over and over, sustained over decades, the way we have at Cooke & Bieler, one notices an interesting fact. The returns earned on equity are higher than the returns paid to debt! Is this just an odd accident of history? Of course it isn't. Academics point to the volatility of returns in explaining the difference, but we think it is more useful to focus on the issuers rather than the buyers. It is the equity owners, acting through management, who choose to issue debt. Since it seems safe to assume equity owners would rather have more money than less, it follows that equity owners only issue debt if they expect to make more money by doing so. And this is why equity returns are higher than debt returns.

To belabor the point a bit, imagine firm ABC. ABC has a \$100M plant building ePads and they make \$10M/year. They have no debt, they pay no taxes and life is easy – the owners get \$10M a year, earning a 10% return on their investment in their plant. Suppose also they want to build another identical plant. They don't have \$100M lying around, so they go to a bank and borrow \$100M at 5% interest. Their life is now a little more complicated, but also more lucrative. Their plants now make \$20M a year, they give \$5M to the bank and take home \$15M. Since their \$100M equity investment hasn't changed – they borrowed all the new money they needed – they earn 15% on their investment. The returns to the equity owners are higher than those to the

But, since it's the fundamentals of earnings, dividends and cash flow that drive returns, it's also crucial to realize those fundamentals were unsustainably wretched over the last 10 years. Remember, equity owners only retain and reinvest a company's earnings if they conclude that their returns on investment are positive and higher than bond yields – otherwise they would repurchase shares or pay down debt. Currently, as a group, companies in the S&P 500 retain about 65% of their earnings in the expectation of earning attractive returns. In making this decision, managements must weigh the expected return of their investments against the return from simply repurchasing shares – a number we approximate by using forward earnings estimates. With the S&P 500 expected to earn \$95 over the next 12 months and based upon its current price, each dollar spent on share repurchase adds a little over 8 cents to earnings, generating an 8% return. Managements no doubt expect higher returns, and some companies will do better, but in aggregate, this is the fundamental floor.

So, what does this imply for returns over the next ten years? Again, we show you below. Earnings growth would be 5.2% per year (65% of earnings invested at 8% returns). Assuming total return is zero – that prices go down just enough to offset dividends (we're optimists!) – the aggregate price earnings ratio would fall to 5.6x and dividend yields would rise to 6.3% by the end of the decade. Even a confirmed equity atheist would find such valuations untenably cheap.

Average Earnings Growth in a Flat Total Return Environment Would Produce Unlikely Valuations

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Price	\$1,071	\$1,028	\$987	\$947	\$910	\$873	\$838	\$805	\$773	\$742
Adjusted EPS	\$84	\$88	\$93	\$98	\$103	\$108	\$114	\$120	\$126	\$133
P/Adjusted E	12.7x	11.6x	10.6x	9.7x	8.8x	8.1x	7.4x	6.7x	6.1x	5.6x
Dividends per Share	\$29	\$31	\$33	\$34	\$36	\$38	\$40	\$42	\$44	\$46
Dividend Yield	2.7%	3.0%	3.3%	3.6%	4.0%	4.3%	4.8%	5.2%	5.7%	6.3%
Price Return	(4.0%)	(4.0%)	(4.0%)	(4.0%)	(4.0%)	(4.0%)	(4.0%)	(4.0%)	(4.0%)	(4.0%)

EPS CAGR	5.2%
DPS CAGR	4.7%
Cumulative Price Return	(33.5%)
Cumulative Income Return	33.5%
Cumulative Total Return	0.0%
Annualized Total Return	0.0%

Of course, it's hard to know what investors will do and what valuation they will assign to earnings at any given point in time. But if current valuations remain constant, equity returns will unambiguously outpace bond returns over the next ten years. This will hold true not just in a better earnings environment, but even in a decade like 1999 to 2009 when earnings and dividends made little progress. Certainly, stocks can lag if valuations compress, but there are limits to how cheap stocks can get. We don't know where the term "equity cult" originated and we certainly don't want to weigh in on religious matters. But when it comes to investing, we are confirmed members of the Church of Math and our math tells us that equity returns must be positive and exceed bond returns over the long term.

Source: Financial data was obtained from Bloomberg on October 5, 2010. The material presented above represents the portfolio manager's assessment of the market and should not be relied upon by the reader as investment advice.



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